

## **Conflicts of Interest in Private Banking: The Root Cause and the Real Cost to Clients**

Remarks by Stephen J. Tall  
to the Institute for Private Investors  
May 26, 2010

Good morning! Thank you for coming. And, thank you to Kristi and Charlotte for allowing me the opportunity to meet you.

I'm Steve Tall. Until recently, I worked at a family office for a prominent family in Texas – but probably not the one you imagine. Before that, I was chief administrative officer at Fiduciary Trust Company International, a global private bank and trust company based in New York. I have perspective on the industry of private banking (in which I include trust companies and asset managers) from both the client and the advisor perspective.

As you know, the financial crisis of the last several years cost almost everybody a lot. It also exposed fundamental problems in private banking. Among the issues facing you, the clients of private banks, are:

- Lack of proper attention to capital preservation - or income - or growth - whatever you thought your advisors were doing, didn't seem to meet your objectives
- Lack of continuity in trust officers
- Changes in bank ownership, which impacts the quality of service
- Emphasis on sales instead of service levels
- Expense and fee levels that are inconsistent with investment performance
- Investment recommendations based on bank profitability instead of the client's investment requirements
- Fragmented offerings and expertise, with important service areas downplayed, if not missing entirely
- Firms' internal focus on regulatory issues to the detriment of client service.

I may be poking a hornet's nest – but let me ask, what have I missed?

OK. Why did these problems occur? The financial panic exposed these issues because of the dramatic impact on firms profits and their share prices. The issues were there all the time but obscured by good markets. When markets are generally high, clients may not notice, or care much, that high fees and expenses are draining principal away from portfolios. Also, good returns may mask investment risks that are inappropriate for the client; and the good financial results of the private bank's parent may mask its vulnerability to acquisition or massive trading losses. It's when markets turn decisively downward do these risks come to the surface.

I believe public ownership of these firms is the root cause of the problems I described because the ownership model introduces inherent conflict of interest between public-stockholders and clients. When a firm is publicly owned, the objectives of its

shareholders' – return on capital – are irreconcilable with the objectives of their clients. That's because management has a fiduciary duty to owners that invariably takes precedence over the bank's fiduciary duty to clients. This is a problem in advisory relationships, and I believe even more so when your firm is trustee.

In my view, privately-owned firms deliver demonstrably better performance and service – and ultimately are better at enhancing and preserving your wealth and ultimately that of your heirs. Obviously the most common privately owned firm is the employee partnership. This was once the predominant ownership model in the industry, before firms started to issue public stock.

Another option that you may not have considered is an old idea: you, the client, can be the owner. This is a business model that is common in banking, insurance, and many other industries; a structure in which the business does not issue stock, and the clients – whether they be depositors, policyholders, or trusts – are the owners through their account relationship.

The origin of my interest in this issue and the idea of private ownership was a meeting with Charlotte nearly four years ago – in June of 2006. We met in her conference room over-looking Battery Park, New York Harbor, and the Statue of Liberty. Charlotte had recently returned from this very conference, late May 2006, and she was very excited by the key note delivered by Jack Bogle that year. It was a speech he gave to correspond with his recently released book, Battle for the Soul of Capitalism. Charlotte was gracious to allow me to listen to the audio recording of the speech. Listening to his points made the light-bulb go on. In the context of our current financial crisis, the speech is worth hearing again - it may be available in the IPI archives - and the book is worth reading, or re-reading. Among all the many important points Mr. Bogle makes, the one that resonates most for me is the issue of conflicts of interest between owners of investment firms and their clients.

My view can best be summed up in Mr. Bogle's own words. With his permission, I repeat them for you. He said:

“When I entered this field all those years ago, virtually 100 percent of mutual fund management companies were *privately*-held firms, relatively small, and managed by investment professionals. Since then, they have experienced their own pathological mutation. Today, 41 of the 50 largest fund management companies are *publicly*-held, including 35 that are owned by giant U.S. and global financial conglomerates, largely managed by businessmen bereft of professional investment training. [Ouch – that's a little harsh!] It shouldn't surprise you to learn that these conglomerates are in the fund business to earn a return on their capital, not a return on your (the fund investor's) capital. They cannot do justice to both, for the record is clear that the more the managers take, the less the investors

make. Alas, in the fund industry in the aggregate, you not only don't get what you pay for, you get precisely what you don't pay for.”<sup>1</sup>

This is equally so for the private banks that serve you. Change “mutual fund company” to private bank or wealth advisor, insert statistics from the latest Barron's survey of private banks, and you get the same story.

## **OWNERSHIP MODELS AND CONFLICTS**

These are common ownership models in private banking in order of most to least common.

1. **A wholly-owned subsidiary or department of a financial conglomerate –**  
**Conflicts:** The private banking division is usually a small cog in a much bigger wheel, and plays second fiddle when it comes to resources. In addition, corporate management may regard private clients as naïve customers for profitable and complex financial products. The private bank is also a plum business to be sold if the parent institution falls on hard times.
2. **An independent publicly-traded stock company –**  
**Conflicts:** Here the client's status is hostage to the earnings performance of the bank. The tendency of management to target short-term performance, as reflected in stock price, is a well-documented shortcoming of publicly traded companies. As the source of top-line revenue, the private client should be prized by the bank like a champion thoroughbred, but is often thought of simply as a cash cow. Also, publicly traded companies are more open to changes of ownership, either friendly or hostile. At the very least, managers are focused on maximizing cashflow to maximize market value of their owners stock. This drives them to focus more on growth – that is gathering assets from new clients or cross-selling – than they are on serving the clients they have.
3. **A closely-held stock company owned by its senior employees –**  
**Conflicts:** In this case, as well, the client is hostage to the bank's earnings performance, although management's focus here is solely on current earnings, and not stock price. However, many of these private banks were started with the ultimate, if unstated, purpose of selling the institution once its business reaches critical mass. Because such an end objective is almost never stated to clients, they are often taken by surprise if and when it happens.

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<sup>1</sup> Bogle, John C., **The Battle for the Soul of Capitalism**, Remarks At the Miller Center of Public Affairs, The University of Virginia, Charlottesville, VA, February 8, 2006 ([http://www.vanguard.com/bogle\\_site/sp20060208.htm](http://www.vanguard.com/bogle_site/sp20060208.htm))

## **THEY EARN A RETURN ON THEIR CAPITAL, NOT A RETURN ON YOUR CAPITAL**

Recall Mr. Bogle's words from the passage I read earlier: "[these firms are in business] to earn a return on their capital, not a return on your (the investor's) capital."<sup>2</sup> Profit motive is not inherently insidious, but as I have said, it can lead to outcomes that favor owners at the expense of clients.

In fulfilling their duty to their shareholders, management's primary strategic goal is to generate a growing stream of profitable earnings by increasing revenue and decreasing costs. And many firms have a fundamental economic problem – revenue can be very volatile because it tracks market performance closely, yet expenses tend to grow at a steady rate – with a fairly high fixed cost component.

You will be better able to manage these conflicts if you know what to look for. Here we have a list of common practices – practices that benefit owners over clients. These should be on your due diligence checklist.

1. **Corporate transactions impact continuity in fiduciary relationship** – You, the private investor, the client, desire multi-generational continuity in your fiduciary relationship. You want confidence that the firm that has been serving your family for generations will be able to serve your family for years to come. Over the last decade, a number of corporate transactions have occurred that enriched the shareholders (and often management, who owned substantial numbers of shares) but provided no apparent benefit to clients. In many cases, the transactions resulted in loss of independence of the bank or investment firm, and resulted in fee increases, reduced service quality, and other problems for clients. This is not only a phenomenon among larger institutions, but is a very common occurrence among small firms owned by a small group of partners once they reach retirement age.

Example: Probably the best known example of this is the sale of U.S. Trust to Schwab and then to Bank of America. Among all its clients and owners, past and present, I believe the parties that benefited the most from its sale were the shareholders that sold to Schwab.

2. **Centralizing and standardizing** – Serving you is very labor intensive and therefore expensive! Trust departments and “old line firms” are generally not very profitable. Serving you well requires knowledge of your unique needs, circumstances and trust instruments, and deep expertise in trust and estates and tax law. On the other hand, firms in pursuit of profit improvement, try to keep a lid on operating costs by implementing centralized and standardized operations. That's very difficult to do in a trust department. Also, in many firms, trust services are provided more or less for free as a part of the asset management price – trust services are like peanuts on the bar: you get them free so the bar can sell

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<sup>2</sup> Bogle, John C., Ibid

more beer. Trust departments, in other words, tend to be loss leaders, and that is not sustainable, so clients experience slow erosion in service quality.

Example: Northern Trust segments its clients into varying wealth tiers and provides a highly standardized service to their clients with less than \$25mm in assets. And, no matter what their marketing may say to the contrary, company insiders tell me that relationships above that threshold are less profitable and professionals there are increasingly coming under pressure to increase their client workload.

3. **Staff cuts** – Private banks operating costs are typically 80% or more in payroll, so when stockholder-owned companies experience reductions in revenue, it is common practice to mitigate the impact on their profit and stock price by reducing staff across the board. This action is what the public markets expect. When investment and trust department staffing is reduced to control payroll expense, the professionals with knowledge of the client's requirements and trust instruments will either be terminated, or burdened by increased workload transferred from those that are terminated. The consequence is a reduction in service quality and an increase in fiduciary risk.

Example: U.S. Trust, which has had a succession of owners over the last decade, has experienced very deep cuts in staff imposed by its large commercial banking parent company, demoralizing the organization, leading to hundreds of experienced staff departures, and upsetting clients. I understand that of the 1,900 personnel at U.S. Trust at the time of the Bank of America acquisition, fewer than 400 of the original professionals remain.<sup>3</sup> A huge brain drain that is surely impacting clients.

4. **Lack of investment in service improvements** – You expect sophisticated service capability – efficient accurate operations, a wide array of timely reporting, and online access and tools. However, in large diversified financial companies, the divisions that provide your asset management and fiduciary services compete with other divisions for resources to improve operations and grow the business. Projects, such as system implementations, or introduction of new services, require staff and funding that are allocated by corporate management across a range of choices based on the expected internal rate of return of the project. In many instances, the smaller business units, such as trust departments, with lower margin, cannot compete for staff and funding because they don't deliver internal returns competitive with bigger and more profitable business lines. As a consequence, trust departments and private bank divisions of large institutions are starved of sufficient resources to sustain high quality service.

Example: Franklin Templeton, my former employer, applies a 15% internal rate of return hurdle on all capital outlays. The trust division has to compete with their

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<sup>3</sup> Federal Deposit Insurance Corporation, Call Report, Cert # 34061, December 31, 2006 and interviews with former U.S. Trust employees

much larger mutual fund affiliate for capital. And, it's no contest. The return from allocating business capital to starting a new fund is much more attractive than implementing a new reporting system or other service improvement.

5. **Cross-selling** – You expect objective advice, free from the firm's interest in increasing their “share of your wallet.” Have you ever heard that phrase? It's banker-speak. Make no mistake, most of the firms in this business pursue the singular strategy of gathering assets to gain the margin upside from economies of scale and enhance their stock price. They will tell you that increasing market share is the result of providing good products and service. I say that increasing market share is the result of aggressive sales and cross-selling. You, the private investor, are a tantalizing prospect for diversified investment firms and commercial banks, because they can introduce you to other, perhaps more profitable products. Many of which may be wholly unnecessary or, worse, inappropriate. This raises at least the appearance of a conflict of interest.

Example: one institution I know uses their parent-company's affiliated actively-managed funds as a default for asset-class exposures that the managers can not provide efficiently. They adhere to the letter of banking law in doing this – but they are not actively shopping for the best available fund in the market. Every month, the management committee receives a report that tracks the increasing volume of affiliated funds placed in their clients' portfolios and actively promote their funds' use by the firm's portfolio managers.

6. **Proprietary trading** – You expect the best advice money can buy – and you expect your firm to devote their talent to maximizing your investment return. Large diversified banks with sophisticated in-house trading capabilities are known to dedicate substantial infrastructure and intellectual capital to maximizing their returns on the bank's proprietary investments. This typically deprives other bank divisions of the skills and capabilities to provide clients the same investment opportunities and results. Even more troubling, it can put them on the opposite side of the trade from their clients. Or worse, give the bank an information advantage over their clients that can be exploited for enormous trading gains.

Example: two names: Goldman Sachs. Need I say more?

7. **Fees** – You expect fair pricing that will motivate your advisor, cover their costs, but not impoverish your heirs. Owners are, of course, seeking a competitive return, thus putting upward pressure on fees. Fees, however, diminish the value of the corpus of a trust or the principal of an investment portfolio, thus imposing opportunity cost from the diminished future value of the portfolio. The higher the fee, the greater the impact of lost future investment gains. This is an important concept: The higher the fee, the greater the impact of lost future investment gains – this is opportunity cost. Over twenty years, fees and opportunity costs can be tens of millions of dollars on a portfolio with a starting value of \$100 million.

## THE MORE THE MANAGERS TAKE, THE LESS THE INVESTORS MAKE

Since fees are ultimately the most tangible area in which you as the client can benefit from improvement, let's see the actual costs that fees impose on your return. Recall the statement made by Mr. Bogle: "the more the managers take, the less the investors make."<sup>4</sup> I will show two scenarios and calculate just how much you make, how much your manager takes, and the resulting opportunity cost.

First, some assumptions. Let's say you invest \$100 million for 20 years and you get a return of 12% from a well managed, long-only equity portfolio. For simplicity I leave out inflation, taxes, annual withdrawals, and transaction costs. Given our starting assumptions, your portfolio will achieve a gross gain of \$865 million – in other words, your portfolio will be worth \$965 million after 20 years.

<b>BASE CASE</b>	
<b>ASSUMPTIONS</b>	
Amount Invested \$	100,000,000
Investment Duration (yrs)	20
Average gross return	12.00%
<b>RESULTS</b>	
Your portfolio is worth \$	964,629,309
You make \$	864,629,309

### Scenario 1

<b>SCENARIO 1</b>	
<b>ASSUMPTIONS</b>	
Amount Invested \$	100,000,000
Investment Duration (yrs)	20
Average gross return	12.00%
Management fee	1.00%
<b>RESULTS</b>	
Your portfolio is worth \$	788,977,004
You make \$	688,977,004
Your managers take \$	70,924,103
And you give up an additional \$	104,728,202

Our first fee scenario is very common. Let's say you pay 1% for this long-only equity portfolio. Over 20 years, when charged 100 bps, your portfolio will be worth \$789 million – a gain of \$689 million. That's \$176 million less than the gross gain. So, where does the \$176 million go? The manager? No, not entirely. Of that \$176 million, the

<sup>4</sup> Bogle, John C., Ibid

manager makes “only” \$71 million over the 20 years. This of course goes to pay staff, rent and other expenses. The other \$105 million is opportunity cost.

To review: opportunity cost is the foregone future returns – the lost opportunity – from the withdrawal of principle from the portfolio. Add the net gain and the manager fee, and compare to the base case, and you will see that some other value is missing. That's opportunity cost.

## Scenario 2

Let's see what happens if you pay less for the same results. Let's say you were able to get a discount of 20 bps. Your manager takes \$58 million over 20 years – still a handsome reward. And the opportunity cost? Now \$85 million.

<b>SCENARIO 2</b>	
<b>ASSUMPTIONS</b>	
Amount Invested	\$ 100,000,000
Investment Duration (yrs)	20
Average gross return	12.00%
Management fee	0.80%
<b>RESULTS</b>	
Your portfolio is worth	\$ 821,474,140
You make	\$ 721,474,140
Your managers take	\$ 58,216,934
And you give up an additional	\$ 84,938,236

That means under this scenario, you make \$721 million – \$32 million more than Scenario 1 because of the fee discount.

	<b>FEE SCENARIOS</b>		<b>DIFFERENCE</b>
	<u>1.00%</u>	<u>0.80%</u>	
Your portfolio is worth	\$ 788,977,004	\$ 821,474,140	
You make	\$ 688,977,004	\$ 721,474,140	\$ 32,497,136
Your managers take	\$ 70,924,103	\$ 58,216,934	\$ (12,707,169)
And you give up an additional	\$ 104,728,202	\$ 84,938,236	\$ (19,789,966)

These are two simple examples. You may be astounded at the impact that a 2 and 20 arrangement has on a portfolio – not just the size of the fee, but also the enormous opportunity cost.

So, what is it worth to you - and maybe more importantly to your heirs - to pay lower fees? And, what if you had control of costs?

## **MUTUAL OWNERSHIP MODEL**

Going back to the beginning, I will elaborate on the mutual ownership concept. I believe that client-ownership offers key advantages including better balance of the interests of clients and the organization that serves them. Based on dozens of meetings with hundreds of principals and their representatives, I found that this model's greatest appeal to wealthy families is control - control over service models; control over management; and, control over long-term independence to ensure continuity in service to future generations. Perhaps most importantly, clients have control over costs. Why pay a profit premium to a third-party, when you can keep the savings and re-invest it?

How does a mutual bank work? In short, clients (aka, members) are accountable for governance and business success. This requires capital support as well as involvement by members to ensure that the organization achieves its goals. But, mutuals keep the profits and pass the savings along to their members.

Mutuals are capitalized by charter members. All the firm's account holders are members and have voting rights. The members elect the board and approve other vital measures that are put to a vote in an annual meeting. The members also have a claim on capital in the event of a capital distribution or voluntary dissolution of the association.

No ownership model is perfect, and mutual ownership is no exception. The first consideration is that mutual ownership requires a commitment of capital to the company. The second consideration is that mutuals require active involvement of members to operate successfully.

No pain, no gain!

I could go on and on about mutuals, as Kristi well knows, but that would be off topic, so I will end here.

Questions?